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Meeting of the Federal Open Market Committee

November 5, 1986

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Wednesday, November 5, 1986, at 9:00 a.m.

PRESENT: Mr. Volcker, Chairman
Mr. Corrigan, Vice Chairman 1/
Mr. Angell
Mr. Guffey
Mr. Heller
Mrs. Horn
Mr. Johnson
Mr. Melzer
Mr. Morris
Mr. Rice
Ms. Seger

Messrs. Boehne, Boykin, Keehn, and Stern, Alternate
Members of the Federal Open Market Committee

Messrs. Black, Forrestal, and Parry, Presidents of the Federal
Reserve Banks of Richmond, Atlanta, and San Francisco,
respectively

Mr. Bernard, Assistant Secretary
Mr. Bradfield, General Counsel
Mr. Truman, Economist (International)

Messrs. Balbach, J. Davis, R. Davis, T. Davis,
Kohn, Ms. Munnell, Messrs. Prell and Siegman,
Associate Economists

Mr. Sternlight, Manager for Domestic Operations, System
Open Market Account

Mr. Cross, Manager for Foreign Operations, System
Open Market Account

1/ Entered the meeting after action to approve minutes for meeting
of September 23, 1986.

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Mr. Coyne, Assistant to the Board, Board of Governors
Mr. Roberts, Assistant to the Chairman, Board of Governors
Mr. Gemmill, Staff Adviser, Division of International
Finance, Board of Governors
Mrs. Loney, Economist, Office of the Staff Director for
Monetary and Financial Policy, Board of Governors
Messrs. Simpson and Slifman, Deputy Associate Directors,
Division of Research and Statistics, Board of Governors
Mrs. Low, Open Market Secretariat Assistant,
Board of Governors

Messrs. Broadus, Rolnick, Rosenblum, and Ms. Tschinkel,
Senior Vice Presidents, Federal Reserve Banks of
Richmond, Minneapolis, Dallas, and Atlanta,
respectively

Mr. Beebe and Ms. Clarkin, Vice Presidents, Federal Reserve
Banks of San Francisco and New York, respectively

Ms. Gonczy, Assistant Vice President, Federal Reserve Bank
of Chicago

Mr. Meyer, Research Officer, Federal Reserve Bank of
Philadelphia

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MR. CROSS. [Statement--see Appendix.] And I might say that this morning, following the elections, it had been expected that a Democratic victory would lead to some weakness in the dollar. There was a very temporary decline in the Far East with the dollar moving down from 2.06 to 2.04 [against the mark] and comparably against the yen. But that lasted only a few hours and in the evening before Tokyo was closing the dollar was beginning to move back up. Subsequently, in European markets, it has moved back to about 2.06-3/4. So it is now at a higher level than it was yesterday.

CHAIRMAN VOLCKER. Are there any questions or comments on the swap extensions?

MR. BOEHNE. Is there any more to say about the so-called agreement between the Americans and the Japanese--particularly what it might portend for the future?

CHAIRMAN VOLCKER. Well, what it may portend for the future is anybody's guess. I don't know anything more about it. Mr. Baker has been looking for some reason to say something nice. And he had it with the discount rate reduction and this report that the Japanese might reduce taxes sometime in the future. But they said it hasn't got any operational significance in terms of intervention in any direct sense. I think it is quite consistent with intervening if things perhaps became extreme in either direction, but it is no commitment to undertake anything.

MR. BOEHNE. The view on Germany is essentially as it has been and--

CHAIRMAN VOLCKER. Germany? I think the situation is quite different in Germany in the very short run. They have been growing pretty fast. I saw Mr. Poehl earlier this week and he's still armed with all these numbers, which I--. You can argue that 3 percent is too modest an objective for Germany. But they can make pretty good progress if they are growing at 3 percent--which in their view is good enough--with 5 to 6 percent domestic demand and a minus on the external side, which of course is what people want. And right now they can show it at least for two quarters. Their monetary growth is still exceeding their targets by a significant amount, which doesn't make them very happy. They are sitting there worried about how they are going to explain this. They have to announce new targets in December and they say: Do we rebase or do we [unintelligible]? It's the same type of problem that we have.

VICE CHAIRMAN CORRIGAN. You're in a position to give a lot of advice on that subject.

CHAIRMAN VOLCKER. I did. His charts for the first time--he showed me charts [unintelligible] just like the ones that we have, but for two years [changing] the base. One chart has a very expanded scale on the vertical axis, just the way some of ours do. The chart looks at the last two years and it has these little wedges on it and it shows the actual movement in the monetary base. And the actual movement for two years in a row now is way above the wedges. While

they've been closer than we have, their scale was so expanded that it looked pretty bad. It was just like the kind of thing that you--

MR. MORRIS. Well, they have real wages growing at about 5 percent in Germany--

CHAIRMAN VOLCKER. They did this year.

MR. MORRIS. --at a time when the unemployment rate is almost 9 percent. I would think that if we had that situation we might be a little nervous about expanding too much as well.

MR. TRUMAN. But the wages were really set, basically, before the prices went down. And so real wages on this [unintelligible] economy. That's one of the questions: whether or how long this recovery is going to be sustained. The basic wage bargains were set before they had experienced the effects of lower oil prices and [unintelligible] and the exchange rate change and prices came down.

MR. MORRIS. That's true. But they still settled for the 5 percent wage increase at a time when the unemployment rate was very high. I should think that--

MR. TRUMAN. Some of that was deliberate, too. Last fall, in fact, the government was talking of wages as a way to--

CHAIRMAN VOLCKER. Their GNP deflator--that's domestic prices--is running at about a 3 percent annual rate of increase. It's like ours running higher than the CPI; there is an even sharper discrepancy than in this country. There is concern over what might happen as they get into next year. I guess their Economic Institute's projection has raised some question about it. A 3 percent growth next year--which is what they're projecting--depending upon what happened last quarter and what happens this quarter does not imply a 3 percent rate of growth from fourth quarter to fourth quarter next year but significantly less than that.

MR. HELLER. But the labor markets in Germany are very tight right now in skilled workers. They just can't hire anybody. Openings are--

CHAIRMAN VOLCKER. But their unemployment is in the north. That's what they keep saying, it's a regional--

MR. HELLER. Also a sectoral unemployment.

MR. MORRIS. So they're like the British in that sense.

MR. HELLER. And because they have the enormous terms of trade gains in the external sector they [can] pay the high wage this year without hurting themselves domestically in making it show on the inflation front. But I think the difficult situation will be next year when the terms of trade don't improve any more and people have become accustomed to big wage increases.

MR. MORRIS. Exactly.

MR. HELLER. But if the weakness should show through, I think they're fully prepared to move forward to 1987 the tax cuts that they are now scheduling for 1988--although those deadlines are passing very rapidly right now.

CHAIRMAN VOLCKER. Well, they won't do anything before the election and part of the--

MR. HELLER. Not before the election, but--

CHAIRMAN VOLCKER. Part of the problem is that the opposition party adopts an American view to economic policy, or vice-versa, which is very embarrassing to the government. So if they did anything they would appear to be adopting the opposition's economic view; and for understandable reasons they don't want to do that. Actually, the Bundesbank wants to take some technical actions that appear as tightening and wouldn't really be--I don't understand it all. They want to get rid of rediscount quotas, which they think are getting out of line, and substitute some other way of putting the money in the market. But I'm afraid if they do that it will be interpreted as a tightening.

MS. SEGER. Is it true that they were willing to cut their discount rate in August but the word got out so they were upset? There was a little article in today's paper to that effect.

MR. JOHNSON. Well, the words I've heard are literally that there was more pressure at one point to raise the discount rate because of the growth of the aggregates.

CHAIRMAN VOLCKER. I think that was probably a little later. My impression is that earlier [Mr. Poehl] maneuvered so as to be potentially in a position to reduce the discount rate in early September, say, which is what he was talking about. But then the aggregates got high and there was all the public discussion and so forth, and the GNP numbers came in as strong as they expected. All those things together made a discount rate cut less likely rather than more likely as September actually arrived.

MR. FORRESTAL. Can you give us any more information about the Mexican situation? Specifically, is it in difficulty or--

CHAIRMAN VOLCKER. Well, that's hard to tell. It's a big subject. Why don't we have a discussion about Mexico after the meeting? Are there any other questions about the market? We do have this question of routinely extending the swap lines.

VICE CHAIRMAN CORRIGAN. I would move it.

MS. SEGER. I second.

CHAIRMAN VOLCKER. Any discussion of that? If not, you are authorized to routinely roll over swap lines, Mr. Cross.

CHAIRMAN VOLCKER. Mr. Sternlight.

MR. STERNLIGHT. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Questions or comments?

MR. MELZER. Peter, do you have any thoughts on the decline in the demand for excess reserves?

MR. STERNLIGHT. We were steadily moving up our allowance for excess reserves. We had moved the standard allowance up to \$900 million in the first few months of this year. Since about March or April we have tended to fall a trifle shy of that \$900 million level. And now we think that maybe the demand was augmented somewhat in the early months of this year by some seasonal factors. So, I'm not convinced of any basic decline in the demand for excess reserves. I think it has probably leveled off and what we are seeing now is just a little resistance for seasonal reasons. We will have to be watching carefully as we get toward the winter months again to see whether we need to review that and go back to something like the \$900 million level.

CHAIRMAN VOLCKER. If there are no other observations, we have to ratify the transactions.

MR. MORRIS. So moved.

MR. JOHNSON. I second.

CHAIRMAN VOLCKER. Any objections? Mr. Prell will clarify the economic outlook.

MR. PRELL. He will attempt to. Thank you, Mr. Chairman.
[Statement--see Appendix.]

MR. BOEHNE. I wonder if you could elaborate further on your discussion concerning the recent increase in import prices--but in terms of how you see that improving our trade balance and how you see it impacting the domestic price level.

MS. HORN. I would like to piggy-back on that and ask: How do they come through in the CPI? Do you have an estimate or rule of thumb that you use about what proportion of the CPI is import prices and so on?

MR. PRELL. Well, let me just say a couple of words, and I know Ted Truman will want to address the broader issue. The more interesting recent data on import prices were the BLS figures that were released just last week. They showed a substantial increase in the prices of a number of commodity groups--something on the order of a 12 or 13 percent annual rate of increase. On the consumer price side, it's very hard to trace these changes in import prices through to what is happening at the retail level. It's apparent that some of those groups that would seem to have relatively large import components, say, apparel and automobiles, are showing relative strength in terms of consumer price movements. But it's very hard to pin this down. Let me let Ted say something about the broader analytical issue on the pass-through of that sort.

MR. TRUMAN. On the consumer price level there are three channels: the direct impact from higher prices, the indirect effects of competing goods, and then some allowance for aggregate demand

effects. We used to say that the rule of thumb was that something like a 10 percent decline in the dollar on the G-10 index would give you, after three years, something like a 1-1/2 percent increase in the level of the CPI. But the work that we have looked at recently suggests that it may be a little less than that--perhaps something in the 1 to 1-1/2 percent range. One of the reasons it is less relates to the same phenomenon that we have debates about--what is the right index? The prices of some imports--especially to the extent that they are imports from countries against which the dollar is not falling--will not be rising as rapidly as the others. It is through that differential effect, however, that you are essentially going to change the distribution of trade. As far as the general question about [prices] feeding through, ultimately you have to get some prices up in order to get some consumers or importers to change the way they are doing business. And in that sense there is both good news and bad news in the price increases that now seem to be coming along. The good news is certainly that the process that should lead the decision-makers to look elsewhere--maybe at home--to satisfy their needs is starting. So far there is certainly some evidence of slowing in the rate of growth in the volume of imports. I might also add one small footnote on the BIS figures that came out on Friday that Mike referred to: the revisions show a higher increase in import prices than the numbers that were incorporated in the GNP figures that were released earlier in the month. That would suggest that for a given value of imports you would get less quantity, *ceteris paribus*.

MR. HELLER. In the Greenbook data in that first table, I-7, you have some amazingly good news that you didn't even refer to in the oral presentation or the written material, and that is a 0.4 increase in the GNP deflator for the fourth quarter of 1986--unless it's a typo. Would you tell me about this?

MR. PRELL. It's 0.7. This is one of those quarters in which the movements in imports and import prices do something very exotic to GNP prices and, particularly, the deflator. As you can see, the third quarter was 3.6 percent. It was above the recent trend and [the fourth-quarter number] is essentially offsetting that, given the gyrations of imports and the effects of changes in the relative importance of oil prices.

MR. HELLER. But you just said you expect import prices to go up and--

MR. PRELL. All things equal, rising import prices drive down GNP price measures in the short run because imports are subtracted. That is one of the recurring novelties. I think if you look at the fixed weight measures we are getting some of this showing through.

MR. HELLER. Too--

MR. PRELL. But it's smaller in effect there.

MR. PARRY. There are two effects. It's the change in weights and then the change in prices.

SPEAKER(?). One question about the near term: I noticed that you have a fair runoff in farm inventories and also an increase in government. Is that an offset? Is there a CCC thing going on there?

MR. PRELL. Let me check. Yes. We have a \$4-1/2 billion increase in CCC inventories. That's roughly the range we have been seeing the last couple of quarters, so there is no gyration in that. Basically, it's something that goes through from our overall output estimates.

MR. PARRY. Well, that should show up in government spending at the same time. It didn't last quarter, I don't think. Government spending last quarter actually declined very substantially. The rate of growth in the fourth quarter was up, so maybe it just got swamped.

MR. PRELL. Defense spending in the third quarter was flat and we have a noticeable uptick based on what we would perceive to be the deliveries. Obviously, there is some very erratic timing; some procurement items show up or don't show up in any given time period.

MR. PARRY. Are there any indicators that support the slowing in state and local spending to that extent?

MR. PRELL. We don't really have much to go on there. There is some elusiveness in tracing the data that we do see to the BEA's translation. We can track what is published for construction put-in-place in the state and local sector, but BEA does considerable massaging of those data in estimating the structures component of state and local expenditures. Basically, in terms of the overall budgetary situation, we just don't see the likelihood that that kind of growth can be sustained. In fact, we have been averaging something like a 45 percent annual rate of growth in state and local construction over the past two quarters; it has really jumped up very rapidly. So, we are looking for that to level off quite a bit.

MS. SEGER. Would you answer a couple of questions about the distribution of activity in 1987? Specifically, for producers durable equipment you have a rather significant pickup between the increase in first quarter of next year and the remaining portion of the year. From your general comments I am trying to figure out why you would have it picking up that much.

MR. PRELL. Well, we have [unintelligible] this tax effect built in. It's rather small but when you annualize these things they begin to look bigger. In effect, we have a small payback on the equipment side in the first quarter of next year because we are assuming that they will succeed in accelerating some of their purchases into this quarter and thus capture the more liberal depreciation allowances.

MS. SEGER. So you don't see a negative tax reform impact, then, beyond the first quarter?

MR. PRELL. We perceive that there is some increase in the cost of capital. The tax law changes, if nothing else were changing the outlook, would be tending to depress capital spending. But all the other considerations--including the fact that, as we perceive it, real interest rates have declined considerably over the past year or so and there is a long lag in the effects of that on spending--are tending to offset that change. Furthermore, we think that as output [unintelligible] demand, firms--particularly in the manufacturing sector--will be more inclined to move ahead toward modernization,

replacing their older equipment, and continuing their efforts to reduce costs and increase productivity. It's not really a very rapid growth of investment spending, but we think there is a reasonable foundation.

MS. SEGER. I guess I am just more nervous about it, but I can't quantify my--

MR. PRELL. We are still in a situation where it's hard to assess the effects that have already occurred because of anticipations or uncertainties relating to tax reform--whether some of the hit already has been taken or whether people now will move ahead knowing what the laws will be. It is very hard to read the current situation.

MS. SEGER. Also, on residential structures, you have quite a nice turnaround between the second and third quarters of next year and then additional strength in the fourth quarter, if I am reading this correctly.

MR. PRELL. These annualized growth rates for residential investment tend to exaggerate, I think, the movements in housing starts that are in the projection. But we have the single-family sector improving a little as 1987 progresses.

MS. SEGER. Is this an interest rate play or what?

MR. PRELL. Well, part of is, I think. But it's not really a significant interest rate effect. It's more a come-back in terms of the underlying demographic factors. And, as construction in the multifamily area winds down and rents begin to show the effects in that area, it's just going to tip the balance a bit further in favor of single-family home ownership, which we think the demographic factors already are going to be favoring. But we don't have a tremendous change in the overall affordability of single-family homes.

MS. SEGER. Yes, I notice your housing starts are pretty level.

MR. PRELL. On the single-family side, we move from around 1.15 in the third quarter up to just over 1.20 in the second half of next year, so it's not really a dramatic change. The multifamily side is continuing to trend downward through most of next year.

MS. SEGER. A final question on the domestic auto sales: Apparently you assume that the so-called "give-back" will all be accomplished in the fourth quarter of this year and then sales will be sort of flat and unexciting quarter by quarter in 1987.

MR. PRELL. I'm sure it won't turn out that way. Short of forecasting every twist and turn in marketing strategies, we have sales coming back toward what we think will be a reasonable overall pace for the year. But yes, [unintelligible] and is consistent with the payback largely being through by the end of this month and things beginning to turn up a bit--perhaps with some renewed incentives, if necessary. But we don't at this point anticipate that there will be gigantic incentive programs put in place in the near term.

MS. SEGER. So, you are not assuming that GM has really been gambling on this approach and that without these incentive programs they will dramatically [cut back] their production schedules?

MR. PRELL. We see them trying to keep things on a stable level, [given] the actions they took in October to cut back their production schedules. The [unintelligible] of what we pick up suggests that maybe they are going to move toward a somewhat more realistic approach to their production, so we might see something that is a little smoother, in fact, next year without them pushing so hard to maintain what seems to be an unrealistic market share expectation.

MS. SEGER. Thank you.

MR. MELZER. Mike, the trend in personal consumption expenditures has been upward since the fourth quarter of last year. You are really showing a dramatic shift in the fourth quarter, which I guess is primarily autos.

MR. PRELL(?). Yes.

MR. MELZER. Do you try to factor into that the effects of the tax legislation and accelerated big ticket purchases to the extent that you can?

MR. PRELL. Well, we have certainly attempted to do so. Our assessment is that there may be a very small effect. A number of factors lead us to think that it will be small. One is that many people may already have made the big move to buy an automobile before year-end--in September when they could also get the big price cuts and the rebates and the other financing arrangements. A second factor is that, in most states, that sales tax deduction does not bulk very large as a percentage of the price, even for automobiles. And what one can bargain with a dealer for may be more important than that. Many people [don't] itemize their deductions; furthermore, for goods other than automobiles, people generally are going to be using tax tables and this specific purchase doesn't become an important matter in further deductions. So, putting all of these things together, we're looking for just a very small effect in the consumer sector.

MR. MELZER. A related question: What happened to real disposable income in the third quarter?

MR. PRELL. It moved down.

MR. MELZER. I know.

MR. PRELL. Three things seem to be the major factors there. One is that farm subsidy payments were much smaller than they were in the second quarter. Those have been a considerable short-run swing factor this year. The second factor is that consumer prices were up in the third quarter because oil prices [were no longer] going down or flat as in the first half of the year. The third factor, which is also very important in these numbers but is rather obscure, is a substantial increase in personal tax payments that wedges between income and disposable income. We have tried hard to track this down with parties elsewhere in the government, but it remains a somewhat obscure area. It is something that has been a factor in bouncing the

disposable income numbers around over the course of the year. Basically though, we think that underneath all of this is a deceleration in disposable income growth in large measure related to the end of that oil price effect.

CHAIRMAN VOLCKER. Would people like to comment on their own views of the outlook? Bob Parry.

MR. PARRY. I think there have been more signs of possible strength in the economy since the last FOMC meeting than there have of weakness. The signals that we see coming from the Twelfth District, on balance, are really rather positive. Total employment and unemployment figures showed continued improvement in September and they paint a better picture than that for the nation as a whole. As an example, the District's unemployment rate fell in September, in contrast to the nation's, to 6.8 percent; and we've seen employment growth over the past year averaging just under 5 percent compared to 2.2 percent nationally. We also received data on trade from the Pacific area customs districts for August and September and nongrain agricultural exports, particularly cotton and also rice, seem to be benefiting from the lower dollar and also from the effects of the 1985 farm bill. The lower dollar and Canadian strikes are also helping the forest products industry. Aero-space and related electronics are a source of considerable strength in many areas of the District and the service industries are performing well.

At the national level, it would appear to me that the signs are relatively strong--clearly not as strong as the western region, but favorable. Recent monthly statistics that have been mentioned for orders, for new home sales, and for leading indicators in merchandise trade do indicate some strength. And I do believe, similar to the Greenbook [forecast], that the third-quarter runoff of inventories should lead to greater production in the current quarter. And it would seem to me that based upon, admittedly, a very preliminary reading of the third-quarter trade numbers that there is a chance of a turnaround in net exports in the fourth quarter. The monthly trade numbers for August and September looked as though they had improved somewhat and, at least in some of the deflators I've looked at, the prices of durable imported goods are rising rapidly. So it appears as though the prices of U.S. exports are becoming more competitive. In summary, our forecast for growth in '87 is very close to that of the Greenbook. We expect a pickup in inflation next year of relatively modest proportions. The changes in our forecast since the last FOMC meeting produced a little lower rate of inflation next year, so our forecast suggests a better trade-off between growth and inflation than we had before.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. In our District the fundamental conditions are very consistent with the pattern that we've had, really, all year long. The unevenness that I've commented on before certainly continues. Those who are doing okay are really doing quite well, and the weak parts of our District show no particular signs of improvement. I hate to bring the agricultural subject back up, but there has been a renewed outbreak of gloom in that area for two very different and diametrically opposed reasons. First, the flood damage in September was localized, particularly in the central Michigan area,

but in the areas that were hardest hit the crops were virtually wiped out. That, of course, is an adverse condition that's completely unrelated to the basic adjustments going on in agriculture. The opposite problem exists in the other parts of the District. The harvest is now largely completed and I am told that the production has just been huge, phenomenal. While the acreage for total production will be down, on a per acre basis the yields have been very, very high. That means, I think, that the carryover stocks are going to be heavy. The pressure on commodity prices will continue. In the third quarter we do a survey of land values and, again, we saw somewhat of a decline in land values. Whereas we thought we were somewhat in the zone of stability with regard to land values I am beginning to hear that we're going to see another slide off--nothing too sharp--but nonetheless that we have a way to go before we get down to the bottom level. And that suggests some more pressure on the agricultural banks, so we've got more to do there. On the manufacturing side the adjustment process goes on. I might note just a couple of late developments, which I'm sure you've read about. GM has this overhang in the market. They're probably going to close as many as 12 plants and that, of course, will have a significant impact on the District in terms of employment.

CHAIRMAN VOLCKER. How many plants do they have?

MR. KEEHN. Gee, I can't tell you that. But I think 12 would be a fairly big percentage.

MR. BLACK. Almost by definition.

MR. KEEHN. Of that number probably 7 are going to be in our District. We think the employment [effect] could be as high as say, 23,000, which would be a very, very significant number. Another structural adjustment in the manufacturing sector comes [unintelligible] engine. I think I commented the last time that they were thinking about downsizing their domestic production. They have now announced that and will be outsourcing to a heavier degree than they have done in the past. On the inflation side, I think the trend is continuing to be favorable; what I hear anecdotally is very much consistent with what Mike has suggested. On the price side, as I hear it, the conditions are very, very competitive and it's very tough to get price increases to stick. And on the wage side, people are continuing to get three-year contracts and very good work rule changes; average costs are favorable so that the productivity aspects, I think, have been pretty good.

As for the outlook, certainly, our forecast is consistent with the staff's forecast. We have every expectation that the expansion will continue at, say, 2-1/2 to 3 percent. And importantly, we see no current signs that we can fall back into a recession; but on the other side, we don't think that there's a significant risk that we would break out on the up side either. So, we're broadly consistent with the staff forecast.

CHAIRMAN VOLCKER. I keep hearing about all these great work rule changes and enormous hope for productivity increases and I look at these figures and I see no productivity increases. Would Mr. Prell please explain to me the discrepancy between what I hear and what I read?

MR. PRELL. It seems like whenever I'm up here giving a briefing the same question arises about the productivity figures. I think many of these collective bargaining agreements involve the manufacturing sector where the data would indicate that we have been getting fairly substantial increases in productivity--maybe not as much as the anecdotal evidence for individual companies would suggest but, on the whole, quite good gains. For this cycle the gains are much more favorable in comparison to past cyclical experience than for the rest of the economy.

CHAIRMAN VOLCKER. More favorable than past cyclical experience?

MR. PRELL. Well, I guess at least as favorable as--

MR. ANGELL. Yes.

MR. PRELL. --previous cycles in contrast to the overall picture. But, as you know, the total for the nonfarm business sector has been less favorable and the data, such as they are, show that in a number of the more service-oriented sectors we just aren't seeing productivity improvement.

MR. ANGELL. Of course, what this means--and I've had several conversations with our staff over this--is that, with productivity in manufacturing doing what it is and the way we go about measuring it, we have to have negative productivity in the service sector. And that raises the question as to how we measure productivity in the service sector; the fact of the matter is that we really don't. So there is some kind of strange averaging process going on there. I think there's really grave doubt as to what our productivity in the service sector is. But if productivity in the service sector is stronger than we're measuring then that means, of course, that our economy is doing a little better than we are measuring. So there are those two aspects that are very interesting.

MR. BOEHNE. There's another aspect to take--

CHAIRMAN VOLCKER. You don't think more computers mean less productivity?

MR. ANGELL. No.

CHAIRMAN VOLCKER. That depends on how one--

MR. BOEHNE. On this issue of work rules, we have an auto plant in our District run by one of the big three auto makers. They think that their biggest problem in the American [work]place is not so much price or productivity as it is quality--actual quality and the perception of quality. This is such an interesting story that I'm going to visit the plant. I talked to the manager there the other day and he says that they are putting their emphasis not so much on how many cars they can get out in a day but on how many cars they can get out that don't have defects. And they think that is where the payoff is in terms of the market. Now, I don't think our productivity figures capture that sort of thing, but it certainly is an improvement in the output if you can do it right the first time.

MS. SEGER. Yes, but you had to get some work rule changes to improve the quality.

MR. BOEHNE. That's exactly what my point is: that the work rule changes are going into the quality aspects rather than improving the measurable productivity.

CHAIRMAN VOLCKER. It decreases the GNP; we don't have all those repairs that go in there!

MR. PRELL. A different aspect of quality in a more secular rather than cyclical area is the question of quality of the labor force. Some researchers have suggested that [taking account of] the quality adjustment in the labor force--[based on] indexes like SAT scores or mix of workers or whatever--you find that our labor productivity growth trends have not been as bad in historical context as they look. It's a very controversial area.

MR. BLACK. If we have a flu epidemic [unintelligible], Mr. Chairman, that would decrease GNP too.

VICE CHAIRMAN CORRIGAN. [The way] the SAT scores work, [there are] negatives and positives.

CHAIRMAN VOLCKER. [Unintelligible] but that's what he says. Productivity in the educational system is going down.

MR. PRELL. Well, if you wanted to use SAT scores and--

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. I agree with Bob Parry. I think the evidence we're looking at today suggests that the economy is strengthening. We have the new orders in durable goods and capital goods; we have strengthening in basic materials prices. We've been looking for a decline in the trade deficit to really carry the economy next year and we're getting very strong anecdotal evidence that this is taking place. When we had the Beigebook survey I found that every company that was interviewed that does a significant export business reported an increase in export orders--aircraft engines by GE, computers, medical instruments, and so on. Right across the board, there were very widespread increases in orders for exports. We always get very impatient waiting for this two-year lag to take place, but the turn seems to be coming on schedule.

CHAIRMAN VOLCKER. It sure is in our projection. I hope it's there.

MR. TRUMAN. Mr. Chairman, our sense is that the September trade numbers that were released, the so-called statistical month-[end] numbers, were probably better than the underlying trend. So that means that for the sum of these months--October, November, and December--we're going to get some very much worse numbers. If you look at the raw data--not the nice leading indicators President Morris has cited--they are a little peculiar because the export numbers are not particularly good. In fact, most of the improvement in the August and September numbers is in the import side where, although we're expecting a slowdown, we're not expecting a drop off.

MR. MORRIS. [Unintelligible] phenomenon for the last couple of months. And so we shouldn't expect to see them recorded in the actual shipments for another 6 months or so.

MR. PARRY. I'm not quite sure I understand what you're saying, Ted. You have a \$19.3 billion improvement in the real net export position. That's got to show up--

MR. TRUMAN. Half of that is oil. Half of what's going on in this fourth quarter is oil.

MR. PARRY. Yes, but I think it's going to show up in the monthly numbers; if the monthly numbers get much worse than they were in September you're not going to get a \$19.3--

MR. TRUMAN. Yes, but if we had to redo the forecast with the numbers that now exist the third quarter would look better. The fourth quarter might not be changed much.

MR. PARRY. I see.

MR. TRUMAN. And that's based just on the fact that it looks like we've got some lower imports--that we're probably going to get negative numbers, or not so big numbers, on the import side in the fourth quarter. Exports are beginning to come in a lot more, as Mike mentioned. On the current import side our sense is that the monthly number ends up getting built into the quarterly GNP numbers and then you're stuck with them for--

MR. PARRY. So you're comfortable with the second-half improvement?

MR. TRUMAN. Yes.

CHAIRMAN VOLCKER. You're finished?

MR. PARRY. Yes.

CHAIRMAN VOLCKER. Mr. Melzer.

MR. MELZER. Our numbers for the District continue to look pretty good. We continue to have better growth in non-ag employment than we've experienced nationally. Retail sales in the most recent three-month period have gone up more rapidly. And we've had a turnaround on the construction side where we have been lagging a bit; both residential and nonresidential construction in the third quarter were quite strong. Anecdotally, on the retail side, a national retailer in the District mentioned that for three months now they've experienced stronger numbers; he wouldn't describe it as a boom situation by any means, but it's the first time for a long period of time that he has seen three months--August, September and October--with continued improvement in terms of their own sales. On the price side, we had a group of small business owners in for lunch not too long ago and I asked them whether any of the developments in terms of markets and expectations of higher prices were affecting their behavior at all. And there was certainly no evidence among that small group that they felt any better able to put through price increases or

were seeing any major increases in their costs. So, at that level, there is no real change in the price picture.

I would say on the overall forecast that the one difference we might cite is that we would tend to be a little more [positive] on the personal consumption side just because of the rate of increase in income growth over the course of this year versus last year. As Mike pointed out, the fourth-quarter GNP number is more than accounted for by net exports and the inventory numbers; and if personal consumption were to be stronger we could be looking, in the short run, at considerably stronger GNP numbers.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. At the District level, I think our numbers continue to look rather good, although quite varied. Pennsylvania is a state that has characteristics both of East Coast prosperity and some of the problems of the industrial Midwest. But on the whole, the numbers have continued to make us look better than the nation as a whole. At the anecdotal level I have noted a less pessimistic view among manufacturers about the trade business. Two or three months ago they were very skeptical that the drop in the value of the dollar was going to have much of an impact. What I notice now is that their orders have begun to pick up and inquiries to their firms are picking up. They now are feeling a little better--feeling that they may be getting back into this ball game. I think that is a subtle but important harbinger of what might lie ahead.

At the national level, we tend to go up and down in this Committee. I think back over the last year and it seems we get one month of figures that look better and we feel better; and then we come back the next month and the figures are a little less; we sort of go up and down. If we seasonally adjusted it all my guess is that we would conclude that things are probably unchanged. There is a touch better evidence, I think, from the trade side as well as in some of the forward looking indicators. I think we need a little more information to conclude that there has been a significant improvement. But having said that, I think that the latest statistics tend to make one feel a little better about a broadly unchanged outlook.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Well, Mr. Chairman, in the Sixth District the situation has not changed very much over the past six weeks, which is to say that conditions are pretty mixed in the area. Picking up on something that Mike Prell mentioned, there seems to be growing concern that the tighter restrictions on municipal finance and the smaller grants in aid as a result of the tax bill are going to slow the area's efforts to improve the public infrastructure and provide needed social services. The weak areas in the District--that is energy and agricultural--continue to be weak. We got a little benefit from the reduction in the drought situation, but the rains came a bit too late to help most of the crops. Confirming what the staff said about the rig count, we find that in Louisiana the rig count actually has risen slightly in the last couple of months, although I hasten to add that conditions in Louisiana and in that general energy patch are still very, very depressed. Another area that continues to concern a number of people is the office overbuilding situation. In the Atlanta

downtown area it doesn't look too bad; the vacancy rate is about 15 percent. But as you move to the outskirts, particularly with newer development, vacancy rates are as high as 40 percent. That average is not as high as in other cities but office overbuilding clearly is a very serious problem and is continuing to be so. The same is true for multifamily rental units, which are experiencing record high vacancy rates. In spite of all those negatives, as I talk to people I think there is a fair degree of optimism about what's happening not only in the District but in the country. There is a feeling that the faster pace of activity in the third quarter is going to be sustained and there is growing confidence, supported by some of the recent numbers, that the trade sector is going to do better. In fact, we have seen in our District orders from textiles pick up significantly over the past month or two. There are early indications--perhaps more anecdotal than anything else--or some suggestion of a pickup in agricultural exports as well.

Looking at the national picture, our outlook is very much the same as the Greenbook's. We think that for the next several quarters we are going to have a growth rate for real GNP that's close to the 3 percent mentioned in the Greenbook. But that kind of growth is hinging on consumer spending and on an improvement in the trade deficit. We're putting most of our money in those areas, as it were. And I have some concern that perhaps we won't get the kinds of improvements that we're looking for there. So I would think that if there's risk in the economy the risk is on the down side. I say that about consumer spending partly because the discretionary income that people have as a result of the drop in oil prices is beginning to trail off, as are some of the effects of the greater wealth experienced in the form of a run-up in the stock and bond markets. Another uncertainty in the whole picture is the extent to which adjustments to the new tax law have already occurred versus how much more there is to see. We did a little survey, a very informal one, but it suggested that about 50 percent of the businesses that we talked to had built the adverse treatment of capital into their plans before the tax law was enacted. Altogether, I think the picture is encouraging; certainly, the District on average is doing better than the nation as a whole and we think that the expansion is going to continue. But again, I would stress that in my view the risk is on the down side.

CHAIRMAN VOLCKER. Mrs. Horn.

MS. HORN. In the Fourth District we don't really see evidence of a resurgence in the economy nor do we see anything that would indicate that we're going into a recession. As I look around the District I have the opinion that Ed Boehne expressed: that it's sort of more of the same. I think my directors in general and the businessmen I talk to have that opinion. I think we're more concerned in our area about the restructuring that's going on in some specific industries--steel and autos come particularly to mind, although I suppose machine tools could be put on that list as well. But this idea of an unchanged outlook, I think, is embodied in most forecasts and I would have no quarrel with it.

On the District level, one of the interesting stories we're looking at is the steel story. My view is that there is more and more recognition by the management in those companies, and maybe by labor

as well, that the problem is not imports and it's not exchange rates but that the problem is more basic than that--whether you call it overcapacity or whether you call it inadequate demand to support capacity. They are beginning to look at that and simultaneously, I think, are trying to deal with it constructively. Now, whether it can be dealt with or not is another issue, because as they close plants they have pension costs and the fringe benefit liabilities, and I certainly don't see how they're going to deal with that. But at least I see a recognition of what the problem is and an attempt to deal with it. Of course, the USX strike has bought the industry time; it has closed down something like the proportion of capacity the industry would like to see closed down. So a little time has been bought by that. We don't see in our District what Frank Morris sees on the exports side. What we see in the foreign sector is that people are beginning to feel better about import prices and that they are poised and ready to take advantage of that by moving their own prices up as soon as they see the window to do it. I see a shift of attitude in the foreign sector, but that's the one that I see.

CHAIRMAN VOLCKER. Mr. Stern.

MR. STERN. Let me just comment on a couple of the changes in our District because I think the fundamental two-tier nature of the economy is well recognized, and that hasn't changed much in recent months. Perhaps what shows most clearly the distinction between what is happening in the rural areas as opposed to what's happening in the metropolitan areas is that the unemployment rate in the Twin Cities is now down to 3.7 percent. That is really a rather remarkably low rate for our economy. But that kind of prosperity is not translated in general once you move out into the rural areas although, of course, the cattle and hog producers are doing considerably better. Some of the producers in Montana, where they had a drought until this year, and some of the wheat producers and others are feeling better, but I wouldn't want to make too much of that. Certainly, the agricultural problems persist in general. I think anecdotally though, some of what has already surfaced at the table certainly is occurring in our District. There's just an awful lot of talk of potential improvement in exports. That kind of talk seems to be occurring in some considerable magnitude and it's clear that people who are interested in foreign business are starting to feel considerably better. As also has been mentioned, at least as far as we are concerned, pricing remains very, very competitive. One of the striking features that has come up in conversations that I have had with business people recently is that the pricing environment is still very competitive and they are still very, very concerned about their costs and so forth. In general, that would be a healthy aspect, in my mind.

As far as the overall economic outlook is concerned, I have no particular quarrel with the Greenbook forecast. I think that's a respectable outlook and certainly, in the context of the fifth year of an economic expansion, something that I can live with. My intuition tells me we may do a touch better than that, but it is not the kind of thing that I think is going to make a material difference in terms of how the economy performs or in terms of what happens to rates of inflation and so forth, at least over the horizon of the next four or five quarters.

CHAIRMAN VOLCKER. Mr. Corrigan.

VICE CHAIRMAN CORRIGAN. As far as the general economic outlook is concerned I would associate myself with the broad profile of the staff forecast. I think the risks are pretty well balanced. I would add that I would consider an outcome over the next five quarters like the staff forecast quite acceptable, considering where we are in the business cycle and considering the range of structural problems that are out there that really don't have a heck of a lot to do with monetary policy in the short run. One thing that bothers me is that I can't for the life of me figure out what to make of this tax bill. It's so complex. I think we're just going to have to wait and see how that shakes out. But it is a major uncertainty as far as I'm concerned. On the trade side, we too encounter many, many anecdotal comments along the lines that Frank Morris and Gary Stern have mentioned. And at this point I think they're more broadly based by industry groupings. A few months ago we heard some of that in chemicals and paper and that was about it. But now there is some in other industry groups as well. An interesting little side light to that on the other side of the equation--the import side--came up in a discussion Sam Cross and I had with some Swiss people yesterday. Now, Switzerland is not a great exporter to the United States; but nevertheless they indicated to us that just in the past several weeks there had been a very sharp decline in orders at Swiss companies for exports to the United States, presumably concentrated in so-called high-tech and electronic types of products. Again, not that Switzerland is a big exporter to the United States, but it was rather a dramatic report just because it seemed to be so sharp and so sudden in terms of their experience. I have a couple of other anecdotal items. I had a conversation with a fellow from one of the largest mail order houses in the United States at a business leaders meeting we had on the 22nd of October. He told me that in the first three weeks of October--which is kind of the beginning of the Christmas buying season for a mail order firm--they had set records across the board in terms of their mail order business. The other development, which is regional in character or is maybe just in the New York metropolitan area, is that the housing market and the labor market in the New York metropolitan area continue to really be booming. Prices of houses are just out of sight. On the labor market side I'll provide a great vignette: I noticed Saturday when I was out doing a couple of errands that the help wanted signs for part-time workers in service-type establishments seemed to abound. That, of course, is a very local phenomenon, but nevertheless-- Overall, as I said, I think the staff forecast is a reasonable one and an outcome that I would find quite acceptable.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. As I see it, I don't think there has been a lot of change in the business outlook since our last meeting. I think those, led off by Bob Parry, who had the perception that people in the market and other observers think the statistics look a little better are correct. But if you look at them on a moving average basis they're not quite as much better as you might think on the surface. The anecdotal information we pick up from around our District, which had been pretty good, I would say was a tad worse than it was maybe a month ago. When I try to figure that out, I think one of the factors is probably the paucity of any information that suggests that we're getting any acceleration of the upturn. The other thing that seems to me to be more important now is the doubt that business people seem to

have about the effects of the tax law on businesses. For example, one of our directors said at our last meeting that he estimated the tax changes would cost his business \$3 million more in 1986 and \$5 million more in 1987. And I think most of them are viewing it that way. But I think the financial underpinnings are certainly there to accommodate any kind of reasonable upturn that we might have in the economy.

I believe the staff is right in what it has done in the Greenbook projection. As several people alluded to, if you break that projection down between gross domestic purchases and net exports of goods and services, you see that the projection shows gross domestic purchases for next year running well below what they're doing this year. By dividing it that way it focuses pretty crucially on the importance of the net exports side. So, if we are to get an increase in GNP that means that the net exports side of it has to come through. I think that's a reasonable thing to expect; as several people have noted, we are seeing a lot of anecdotal information that this kind of thing is happening. There are all sorts of measures of how much the dollar has depreciated, but when you get through all of those I think you have to conclude that in real terms there has been a pretty significant depreciation in the dollar. So I think it would be rather surprising if we didn't get some kind of a turnaround in our real balance of payments with this kind of improvement in the terms of trade. We think we'll see that more, of course, in the real figures in the GNP than in these monthly census figures on merchandise trade. They may not show up. But after the deflation, I think it's going to show up in net exports of goods and services. I don't know whether it's of any value or not, but one of our economists ran a VAR model and he usually gets results almost diametrically opposed to what the Board staff has; but that [model] suggested about the same kind of improvement that the Board staff has projected. It might concern you more that two models suggest the same thing than if neither did!

CHAIRMAN VOLCKER. What's a VAR?

MR. BLACK. Vector autoregression is what it stands for.

MR. JOHNSON. I think it's a modern times series model.

MR. BLACK. It came along after we finished our graduate work, Mr. Chairman, so we weren't really exposed to it in those days. So, we would buy the staff's forecast and we would say the chances of error are about equal on each side of it.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. Mr. Chairman, I don't have very much new or different to report for the Eleventh District. Things have continued pretty much as they have been. We do think that we're at the trough, as I reported last time, or certainly very close to it. I guess you'd say it has stabilized or has become stagnant, whichever term you want to use. As hard as we're looking, we really don't see any visible evidence of an upturn but neither are we finding evidence that it's getting worse. As a result of our District's economic conditions, the banking situation doesn't seem to be improving. Looking at the national economy, we don't have any real issue to take with the staff forecast. We might tend to be a little less optimistic on real

growth--but not anything very significant--and to a certain degree on the inflation outlook than they projected.

CHAIRMAN VOLCKER. Ms. Seger.

MS. SEGER. As I've been thinking about this year and our different views as we've gone through the year, it seems to me that there has been some general paring of forecasts for real GNP, particularly for 1987. I still think, even with that, that there is some downside risk, particularly in the next 6 to 9 months or so. I hope Mike Prell is right that the auto bulge is going to be straightened out this quarter, but maybe because I'm cynical about the auto industry and things can vary I just sense that they've borrowed more from the future and that it's going to take more time to make that up, unfortunately. Also, I continue to be a worrywart about the consumer debt situation. When I read the article about Sears and its experience with rising amounts of uncollectibles, and so forth, that didn't make me feel any better. Also, in the multifamily housing area I heard a story--anecdotal but I think it may suggest that we have tremendous problems in apartment vacancies--that down in Bob Boykin's area they're giving free braces to people who are willing to sign two-year leases for apartments. I guess that just shows that the dentists own the buildings!

CHAIRMAN VOLCKER. [Unintelligible.]

MS. SEGER. Oh, you can get braces now up to age 60. I'd say the market is probably pretty big. Anyhow, I think it does suggest that there's some urgency here to move people into these empty buildings. Again, that didn't make me feel terribly good. And that's without even considering the tax reform items. I really think that the tax reform is going to hit the multifamily or the apartment area probably as hard as any sector of the economy. It's sure going to knock off some of these limited partnerships that have been used to finance them. And for offices the same is true: there are lots of vacancies and it's very difficult to unload space. I don't believe I've heard it mentioned at the table here but there's a real problem coming up with hotels because so many have been built. It's not just in Washington, D.C. where all the lobbyists control them, but in many parts of the country there has been a lot of hotel construction and it's reaching the point where there is an excess of rooms and some real downward pressure on plans to put up additional hotels. Finally, in relying heavily on the trade turnaround I certainly hope that it takes place. I've heard some stories about additional orders for American exporters or soundings on the possibility of additional export business. But I also continue to hear stories about how difficult it is to meet the import competition from the countries that we seem to ignore, countries like Canada and Korea and Hong Kong. And it seems to me that if we're going to close this gap we've got to address both sides--not just expand our exports but put a damper on our imports. I'm not talking about trade restrictions, believe me. But I don't see a lot of evidence that the import surge is slowing down. So I guess I'm just generally negative today.

CHAIRMAN VOLCKER. Let me ask a question about multifamily housing. I hear about all of these surpluses, which I assume are true, but my impression is that rents are still going up at about the same rate of speed. Is that true?

MR. PRELL. The CPI measure hasn't shown any significant change in the rate of increase recently.

CHAIRMAN VOLCKER. How do you explain that seeming dichotomy?

MR. PRELL. Well, I'm not sure we can. One thing that may be a source of concern about that measurement is the treatment of vacant units. They evidently make some adjustments for the discontinuous movements in rents that occur after units have been vacated. While we can't manage to get into the details of how they're actually doing these adjustments we think there could be some upward bias in the measurement of rent increases recently.

MR. MORRIS. Also, the big recent increases are in the Northeast where the vacancy rates are very low.

MR. PRELL. That's another point. The sample may not be capturing the developments across the country correctly because it may not be representative of the current regional mix.

MR. BOYKIN. There are other things going on, too, that the numbers might not capture. Talk about the incentives on the commercial side! There are a lot of incentives on multifamily units, as evidenced by the signs in front of a lot of these projects saying "The move is on us!" with a picture of a moving truck. They say they will pick up the moving expenses, give free rent the first six months, and then talk about the rental rate later. There are all kinds of incentives at work, so it may be that for reporting purposes the [true cost of a] rental is not actually being shown. By the time you work in--

MR. STERN. It would be interesting to know how long some of these units were standing vacant, actually.

MR. BOYKIN. Jerry Corrigan talked about the very rapid price movements in homes, and we are having that too. In Dover a friend of mine just offered \$100,000 less than the asking price and the owner took it before my friend could even back off.

CHAIRMAN VOLCKER. You have rich friends [unintelligible].

MR. BOYKIN. It was just a \$300,000 house.

CHAIRMAN VOLCKER. Well, it was a \$400,000 house. Mr. Guffey.

MR. GUFFEY. Mr. Chairman, with respect to the national picture, we don't have any serious difference with the Greenbook forecast. This time again, as has been said around the table, that [forecast] depends greatly upon the turnaround in our net export position; absent that we would expect a still positive rate of growth but more in the 1 to 1-1/2 percent range. So it's extremely important that we get that kind of turnaround to achieve 3 percent growth in the next five quarters.

With regard to the District economy, not a great deal has changed. We still have the unbalanced condition that Gary Stern described in his District of the urban versus the rural areas. Urban

areas seem to be doing very well with the exception of the oil patch cities; Oklahoma City and Tulsa still are very depressed, but other cities such as Denver and Kansas City, or even Omaha, are moving along at fairly good clips--particularly the Kansas City area. Manufacturing in the District is very mixed. Auto production--and we are fairly large in auto assembly within the District--is moving along at a full two-shift operation. The rumor that we have heard is that instead of 12 GM plants closing it's only 6 and at least one is in the Kansas City area. However, the offset to that is that there is a very large plant being constructed now in Kansas City; so it may involve just an upgrading of their plant facilities, as far as our local economy is concerned. Interestingly enough, the high-tech sector, particularly the chip industry in Kansas City and in Denver, seems to have an uptick and that is largely attributed to the relationship of the dollar. The strengthening seems to have come about even though their competition was, among others, Taiwan. Although that relationship hasn't changed, apparently they feel that they are back in competition again where they were priced out of competition at an earlier time. With regard to other manufacturing sectors--such as farm equipment and oil field equipment--those are still very depressed, largely because of the agricultural situation.

With regard to agriculture, net farm income will be essentially the same as it was last year. But breaking that down, the red meat sector--I'm talking about hogs and beef prices--has been very good. With the low commodity feed prices they have an all-time good spread; so there is money being made in that. That's being used largely to service some of the agricultural debt and hopefully it will buy a little more time. In the farm sector, we just completed our third-quarter survey and two things fall out of that. One is that the decline in agricultural [land] prices continues. The second quarter showed a decrease in agricultural real estate values of about 2 percent and that continues in the third-quarter survey, as contrasted with a decline of 6 to 7 percent in the fourth quarter of 1985. So the decline is slowing and, hopefully, we are getting at or near the bottom. The other important number that falls out of that survey of agricultural banks is the fact that the loan-to-deposit ratio is the lowest that it has been since our survey started in 1976. That is, it is now resting at a 52 percent loan-to-deposit ratio in agricultural banks. That's largely attributed to the fact that there is a lot of liquidity but there are no good agricultural loans that they can find; as a result, they are sitting with that liquidity.

CHAIRMAN VOLCKER. Mr. Angell.

MR. ANGELL. I think the most unusual development is that we haven't had anyone around the table who has taken exception with the staff's inflation forecast. This is the first time that I remember that someone hasn't suggested that inflation is going to be higher than the staff forecast. That may be good news if that is shared around the producers; it may very well be that we don't have those deflationary and disinflationary forces that may depress the economy. I am getting somewhat optimistic because even though I have stayed with a 2-1/2 percent [forecast] in regard to real growth, it is getting close enough to the staff's forecast that I see very little difference. It seems to me that our economy is rather recession resistant in the sense that the proportion of population of elderly--retired with social security and retirement income--is kind of a nice

floor. Farm programs do provide a safety net, and certainly, the service sector tends to produce income flows to a large portion of the U.S. economy that tends to make it not too susceptible to a dramatic downturn. Certainly, there have been no indications of any inventory accumulation based upon price expectations, and so there is very little danger of any typical inventory-lagged kind of recession. I do think there is quite a bit of risk, of course, of those sectors that the staff is forecasting to increase just matching in very nicely with those that may have been decreasing. So there has to be some risk of that [not] occurring. But I would be at a loss to suggest which way the risk is the greatest. It would seem to me that if we avoid any dramatic alterations in the money growth path downward--. You know, we have been running M1 at a 16 percent path and I think we all find it surprising to look back and see that. If we had it to do over again I am not sure we would have chosen a lower [path], given the way velocity turned out; but if there is any downside risk, it might show up in a rather quick change from a 16 percent growth path to a 6 percent growth path. If that were to occur, we ought to look at that. I don't know whether it is occurring or not; I think there might be some evidence as one might expect. We are getting to nearly three months without a discount rate cut and that's almost unheard of this year; probably in that environment we might expect the M1 growth path to show a change. The leading indicator that I run says that may be happening. So it seems to me that we do have a fairly good outlook.

I agree with Roger Guffey that the meat producing segment of the farm economy, which at times can account for half of net farm income, has profit margins or spreads that are about the best we have seen. Even though we haven't seen a trend toward higher numbers, the feedlot operators know how to keep them in the lots a little longer and have them go at higher rates; consequently, we do have some opportunity for some good food price news, perhaps with regard to some continued downward news in poultry and hogs and finally beef prices. Let me end by suggesting that all is not well on the price front; I think we have a danger. I think it's quite likely that the President will receive on his desk a trade bill before next spring has passed and I think that might pose the first warning sign of a danger on the inflation front.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. Mr. Chairman, I feel pretty comfortable about the staff's longer-run forecast, despite the fact that we are seeing an aging of the expansion of the economy over the next year. I am somewhat less comfortable about the short-range forecast--that is, over this current quarter and the next quarter, largely because the rate of growth that we are expecting is highly dependent on inventories and net exports. And that, of course, [unintelligible] for a fairly chancy outcome. I certainly agree with Wayne that there are a lot of other sectors in the economy that are components of the GNP. So I think that at this time we are forced back more than usual on the anecdotal evidence. I am encouraged by what I hear around the table that basically the feelings and the mood are good and/or better; chances are much greater that we will see some improvement in the short run, over the next couple of quarters, than no improvement. But this is a time when I think we just have to sit back and wait to see what will happen.

CHAIRMAN VOLCKER. Anybody else have any comments?

MR. HELLER. Well, I agree broadly with the views expressed by the staff and by the speakers around the table. In particular, I think three developments are very heartening. First, the reduction in the federal imbalance--and if you take the state and local in together, the deficit is down to just slightly over \$110 billion. Second, the external sector imbalance is being reduced. And third, the agricultural and oil-patch situation [seems to be] bottoming out. So, overall, I think we are seeing a strong reduction in the structural imbalances here. And I think that all bodes well for the success of the staff forecast.

MR. JOHNSON. I don't have much to add. I think just about everything has been said. The staff forecast is looking better and better. The latest evidence is consistent with the pickup in exports, though it may be too early yet for that to be conclusive. But I do think that the anecdotal [evidence] and some of the aggregate numbers are consistent with the staff forecast, so I feel fairly comfortable with that. It comes just in the nick of time, really. Some of the improved aggregate statistics on the trade side along with both the proposed change in fiscal policy and the drop in the discount rate in Japan were timed well. I think [those developments] relieved a lot of the concern building in the financial markets about what was going to happen to the dollar, what kind of pressures that was going to bring on us, and whether the economy was going to remain weak. All of that has led to some relief in the financial markets. You can almost see it; you can see it in some flattening of the yield curve. I think we have a little more breathing room now and I feel a little less pressured than I did last time looking at this situation. Still, I think it is too early to pass judgment on whether we are out of the woods. But certainly, the evidence is consistent with the projection that we have, so I feel better.

CHAIRMAN VOLCKER. Let me just make a couple of comments about the international situation. This was not stated when we were discussing Japan and Germany earlier. So far as Japan is concerned, the most important point to make about their recent actions, particularly the discount rate change--which is good news, I guess--is that undoubtedly they acted because they are really worried about their business outlook now. That's the bad news. I don't think the Japanese economy has looked very good for some time, but the Bank of Japan seems to be convinced that it's not very good and that the growth prospects at the moment are not very satisfactory. Mr. Truman just gave me the announcement of German industrial production in September; the figures just came out this morning, I guess. I don't know what to make of it; it's a big reduction when the August figure, which was initially .3, is revised down to -.1 and then it's -1.7 in September. That gives a rather sick cast to their industrial production. They accompanied the announcement with a statement that they expect an upward revision of close to 2 percent. I don't know what kind of statistics they have [when they release a figure that is] down 1.7 and say they expect it to be revised upward by 2 percent. So think of that what you would like to think. Even with that upward revision it would not be very strong in the third quarter; it doesn't quite bear out these much happier GNP figures they have. I thought that Governor Heller or Governor Angell might mention a little curiosity--I don't know whether it's literally true, but it's very

close to being true--that despite all of this agony in the farm sector, which is very real, we may have record net farm income this year. It's a little odd to have all of this agony at the same time that you have record income, which will almost all be funded by government payments. For whatever reason, there it is. If you don't have any debts on the farm, I guess you are doing all right.

MR. RICE. Mr. Chairman, on Japan: Aren't their exports still increasing?

CHAIRMAN VOLCKER. They think the export orders are actually down.

MR. TRUMAN. Yes, their exports are down. The last couple of months the volume has actually picked up a bit, but I think that may be shipping. When volumes are down, then--

CHAIRMAN VOLCKER. Volume is down year over year.

MR. TRUMAN. The last couple of months they have done a little better, but basically they are down.

MR. RICE. In the last couple of months their trade surplus has increased.

MR. TRUMAN. Well, in dollar terms [unintelligible].

MR. ANGELL. In dollar terms, but not in yen terms. You see, in yen prices--

MR. RICE. Okay.

MR. ANGELL. Yen prices are lower and volume is lower, so the yen value of exports is down.

CHAIRMAN VOLCKER. Of course, that's what's affecting the domestic economy as we feared. Besides that, they don't import much. The big contrast between Japan and Germany is that in Germany imports, including imports from Japan, are going up rather sharply. I don't think Japanese imports are going up much.

MR. HELLER. Domestic demand in Germany is much better than in Japan. That's the big difference. And investment too [unintelligible]--

MR. JOHNSON. How much of that is based on the oil price, and is it going to level off?

CHAIRMAN VOLCKER. Governor Johnson just mentioned this change in the dollar and so forth. I have a better feeling for the moment; I don't know how long it will last. In some sense it gives us a little more flexibility; we may not want to use it, but it removes one constraint on our fine tuning as we go along. Right at the moment, I'm kind of on this [unintelligible] curve. I can't refrain from saying that there are two things that bother me, looking at a longer-term prospective, that are particularly relevant to what we do now. I am struck, particularly [by the comments of] the first people who were talking, that we are doing much better on wages. Mr. Prell

and other people tell us that it really has been quite remarkable. Productivity in manufacturing, at least, seems to be pretty good. They are keeping their costs under control and everybody says all of these manufacturers are sitting there champing at the bit to raise prices. They can't do it, but at the first opportunity that comes along they are going to raise prices. I just wonder about the consistency of these things and what they tell us about the psychology of the American business sector. You have twenty years of inflation, that's normal; and if you can't raise prices that's not normal, even if you are making production gains and keeping your costs under control. There seems to be something the matter there. Then I hear about all of these capacity cutbacks--I don't want to generalize too far, maybe it's just in orders on steel--but if we are going to have these high exports in the future and we are going to have these restrained imports that we are talking about, presumably that means manufacturing activity does a lot better in the United States. I would think some of that improvement in the trade balance has to come in the automobile industry. And if that's true, what are we doing reducing plants by 6 or 12 or whatever it is [unintelligible] increasing them, may be [unintelligible]. But it bothers me.

MR. MELZER. One of the things that I failed to mention is that a big plant, a new plant, in Westfield that doesn't run a third shift has very efficient [unintelligible]. In a downtown truck plant that is closing, 2,000 or 2,500 laborers might get laid off and this other facility expects to pick up as many as 2,000 of those. So, maybe there is some of that going on.

MR. KEEHN. It is a capacity shift as opposed to necessarily a capacity reduction. The plants I mentioned clearly are older and outmoded; it is a way of trimming them as opposed to making a very fundamental, huge reduction [in capacity].

CHAIRMAN VOLCKER. You think in the context of at least maintaining production?

MR. KEEHN. Well, I think they will reduce their production but not in the magnitude that the numbers would suggest. As Roger says, they are adding a plant in Kansas City. They are right; there are a number of plants where they can add a second and third shift to pick up the production.

MR. PRELL. Over the next few years foreign car producers are going to have substantial amounts of added capacity.

CHAIRMAN VOLCKER. How much does that amount to?

MR. PRELL. It seems to me that I have seen figures that by early 1990 it will be 1 million units a year; that's a vague recollection.

CHAIRMAN VOLCKER. One place I suppose we can make gains in that connection is that a lot of these foreign plants were established, I am sure, with the intention of importing almost all the components. But if an American company can get in there and provide more of the components--which seems possible--you get a pickup almost invisibly this time.

MR. PRELL. Some of them are creating their own parts-producing facilities.

MR. ANGELL. Well, I think it's important to realize that what's in the bag is a cessation of the worsening of our trade balance. That is going to show up in the GNP numbers rather substantially just because we have stopped worsening our position. But it remains to be seen whether in a sense we are substantially narrowing that trade deficit.

CHAIRMAN VOLCKER. This forecast has pretty big increases in exports and no increases in imports. And that surely is a change in trend, if it comes about.

MS. SEGER. Getting to the plant closings: if you look at the details I think you will find that they are not all assembly plants. There is a foundry; there are parts plants, etc. And the grim news is that as they close, they will be importing some of those items that GM now produces in Saginaw, Michigan, and so forth.

MR. ANGELL. But the point of it is that there is outsourcing in the United States as well as outsourcing abroad. A lot of this is outsourcing right out of the boundaries.

CHAIRMAN VOLCKER. Why don't we hear from Mr. Kohn and then have our break?

MR. KOHN. Thank you, Mr. Chairman. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Okay, let's have a break.

[Coffee break]

CHAIRMAN VOLCKER. Let's get the show on the road. Who would like to take an initiative?

VICE CHAIRMAN CORRIGAN. I'd like to take an initiative not to take an initiative.

MR. BOEHNE. How about no change?

MR. ANGELL. Ditto.

MR. JOHNSON. I would not mind suggesting one little nuance.

VICE CHAIRMAN CORRIGAN. Is this in the nature of an "ooze" or what?

MS. SEGER. Stampede.

CHAIRMAN VOLCKER. I will take it that this affirmation of no change means no change in the borrowing and presumably in the numbers that we use, although there is a little question as to whether we should move those. I don't think it makes any difference in the numbers if we move the time frame to the fourth quarter instead of from August. I am indifferent, but it's somewhat more normal to use the fourth-quarter figure. That would not make any difference in the

numbers; it just affects the words. Forgetting about the nuances in the language at this point, is that what we are talking about? Okay. The floor is open for nuances.

MR. JOHNSON. The nuance I had in mind is that since the last FOMC meeting perhaps conditions have changed sufficiently to take the asymmetry out of our wording and either leave it totally symmetric or shift the nuance to the other side. It would be fine with me if we made it totally symmetric, but I have a slight preference for shifting the nuance the other way. I think we ought to change that nuance and that's about all.

CHAIRMAN VOLCKER. Can we put on the table taking out at least--

MR. JOHNSON. Take out "would" and use "might."

CHAIRMAN VOLCKER. That's right; make them both "mights" or shift the "would" to the easier reserves part.

MR. BLACK. Mr. Chairman, even though "would/might" sounds like some kind of obnoxious insect such as a tick, I would still like to keep our "would/might."

CHAIRMAN VOLCKER. Well, what is the feeling about symmetry?

VICE CHAIRMAN CORRIGAN. I can go along with symmetry.

MR. BOEHNE. Symmetry.

MR. ANGELL. I would prefer symmetry.

CHAIRMAN VOLCKER. Well, it sounds like a consensus for symmetry. Should these be "woulds" or "mights"?

MR. ANGELL. "Woulds."

MR. BLACK. Yes, I agree with that.

MR. JOHNSON. No, "mights."

MR. ANGELL. No. Symmetry would be "woulds."

MR. JOHNSON. I guess it doesn't matter as long as we use the same word on both sides.

MR. BLACK. This is going to be a long meeting.

MR. ANGELL. Well, this is a very significant issue.

CHAIRMAN VOLCKER. I don't have any strong feeling either [way], but I'd suggest "might" as being slightly more [appropriate]; I don't hear anybody talking about wanting to change now in a very active sense. Mr. Kohn raised a question about whether we want to change "slightly" to "somewhat." Any preference between "slightly" and "somewhat"?

MR. GUFFEY. I think it's "slightly."

CHAIRMAN VOLCKER. On the same theory you would make it "might"--

VICE CHAIRMAN CORRIGAN. "Might" is consistent with "slightly."

CHAIRMAN VOLCKER. What about these [proposed] changes that Mr. Kohn made? On the first reading I don't see that they change anything: change "exceptionally large increase" to "exceptional pace;" and "past" to "previous." What is--

MR. KOHN. The point was that the way it read before it wasn't clear over what period the Committee was expecting M1 to moderate. [The question was]: as compared to what? So I tried, by putting "over the same period" to convey that it was the August-to-December or the September-to-December period compared to "over the summer."

CHAIRMAN VOLCKER. Well, you see more of a difference between "previous" and "past" than I do. Since I see no substantive difference between them, I guess it just raises the question of whether it's worth changing the language.

MR. HELLER. Oh, "previous" is slightly clearer, isn't it? Because "the past" would include the months in the period that he was talking about earlier.

MR. BOEHNE. Do you want "previous might" or "would be"?

CHAIRMAN VOLCKER. [For] September to December I think it makes absolutely no difference, since we had it this way, with "exceptional." It would make just a slight substantive difference if we thought the higher end of this range in September [unintelligible]. August to December means it includes August too.

MR. KOHN. No, it's from an August base; so it would be September, October, November.

CHAIRMAN VOLCKER. So the difference is whether you include September and September was toward the high side. If the figures came in low you have a month of high [growth] that would be in the calculations.

MR. KOHN. Look on page 6, Mr. Chairman. For alternative B, the August-to-December growth we have is 8.4 percent for M2 and 7.4 percent for M3. For September-to-December growth we have the same thing for M2, so that's no difference at all; but it's slightly lower for M3. A range of 7 to 9 percent would do for both.

CHAIRMAN VOLCKER. It's just a matter of presentation. Usually in these mid-quarterly dates we talk about the quarter and not about a period longer than a quarter. Before the quarter this time we did add August; as we sometimes do, we included an extra month. What do you want to do?

MR. ANGELL. Use the September.

CHAIRMAN VOLCKER. Do you want to change to September?

MR. JOHNSON. Yes, that's all right.

MR. ANGELL. I would like to make a case: If the monetary aggregates came in exceptionally weak, I would hope it would not be a "slight" and a "might."

MR. HELLER. I actually disagree with you a little on that one. I think we should look forward to the time when the monetary aggregates would slow down.

MR. ANGELL. Well, we should. But how abruptly?

MR. JOHNSON. If we are continuing to get a good tight economy--

MR. MORRIS. Well, as long as you are not driving interest rates [up] at the same time.

CHAIRMAN VOLCKER. Does anybody else have anything to say? It would read: "In the implementation of policy the Committee seeks to maintain the existing degree of reserve restraint. This action is expected to be consistent with growth in M2 and M3 over the period from September to December at annual rates of 7 to 9 percent. While growth in M1 over the same period is expected to moderate from"--we'll take these refinements; that will produce a whole article in the Fed Fortnightly.

MR. BLACK. Don't you have to take out "respectively," Mr. Chairman?

CHAIRMAN VOLCKER. Yes, we took out "respectively." It's 7 to 9 percent. "While growth in M1 over the same period is expected to moderate from its exceptional pace during the previous several months, growth in this aggregates will continue to be judged in the light of the behavior of M2 and M3 and other factors. Slightly greater reserve restraint might or slightly lesser reserve reserve might be acceptable" etc. And we have 4 to 8 percent on the federal funds rate. Any other comments?

MR. GUFFEY. I think we ought to take a vote.

CHAIRMAN VOLCKER. If we are prepared, we can take a vote.

MR. BERNARD.

Chairman Volcker	Yes
Vice Chairman Corrigan	Yes
Governor Angell	Yes
President Guffey	Yes
Governor Heller	Yes
President Horn	Yes
Governor Johnson	Yes
President Morris	Yes
Governor Rice	Yes
Governor Seger	Yes

CHAIRMAN VOLCKER. We have a couple of housekeeping items. I thought we might meet for two days in December [unintelligible] in the discussion of how we handle next year. That, of course, raises not

exactly a new event but a considerable question about what we do about M1 in particular. So if that's all right we will schedule the meeting to begin on Monday afternoon instead of on Tuesday. Also, I think you have had a tentative schedule of next year's meetings. The only question I am aware of that has arisen is that a couple of people raised a question about the meeting scheduled during Christmas week. I would like to indicate that we work during [unintelligible].

END OF MEETING